Tax Reform in the Commonwealth

David E. Wildasin

Martin School of Public Policy and Administration
and
Department of Economics,
University of Kentucky

Prepared for symposium on “An Economic Perspective on Kentucky Tax Structure”, Frankfort, KY, January 13, 2010.

Introduction

I. Basic Principles, with Illustrations

A. Policy Objectives: Efficiency and Equity

B. Policy Constraints: Cash-Flow and Intertemporal Budget Constraints

II. Taxation in a Changing Economic Environment: Some Issues for Today (and Tomorrow?)

A. Growth of the Service Sector and Sales Taxation

B. Revenue volatility

C. Competition for Human and Nonhuman Capital

III. Conclusion (with a modest proposal).

I. Basic Principles, with Illustrations

I.A. Policy Objectives: Efficiency and Equity

- Normative economic analysis of public policy (all policies, not just taxation) is grounded on the idea that what ultimately matters is the well-being ("welfare") of the population.
- Impacts on everything else – industries, regions, environment, employment – are possible means to this end, not ends themselves.

The Meaning of Efficiency and Equity

- Improving “efficiency” means raising economic well-being. (Making people better off.)
- “Equity” means insuring fairness. (Appropriate limits on inequality, equal treatment of equals.)

Efficiency

As a general rule: resource allocation should be directed by market forces, not by fiscal (dis)incentives.

There are exceptions: When there are market "failures" (public goods, natural monopolies, missing markets), policy interventions may be needed to promote efficiency.

(Almost) All Taxes (and Subsidies) Distort Incentives

Examples:

(i) work incentives;

(ii) investment, employment, and production incentives;

(iii) locational incentives.

Second-best Policies

- All tax/subsidy policies have *some* incentive/efficiency effects. What is the *least* inefficient of many inefficient policy alternatives?
- The problem of “second best”: No “ideal” choices. Better analysis can inform policy.

Are Efficiency Effects Big or Small?

- Taxes (or subsidies) that have minimal allocative effects (on work, employment, investment, location, consumption) tend to be less harmful, on efficiency grounds.
- Long-run effects are larger than short-run: important when considering relatively “slow” adjustments like locational choices, savings/investment, industrial development.

Equity

- Fairness and equity have many aspects, including:

(a) “Vertical equity” and economic inequality.

(b) “Horizontal equity” (equal treatment of equals) and economic neutrality.

What Can Economic Analysis Say About Equity?

- Economic analysis cannot itself say what is equitable.
- But it can provide insights into the distributional or equity effects of policies.
- A prime example: Tax incidence analysis.

Example: Who really bears the burden of taxes on business?

Statutory tax incidence: Businesses *collect* taxes on sales, business profits, payrolls.

Economic incidence: Real burden of taxation d*oes not* fall on businesses as such. Business owners, workers, and consumers bear the real incidence in the form of lower profits, lower earnings, or higher prices.

Alas, no free lunches: *people* must inevitably bear the cost of government.

Assessing the Distributional Effects of Taxes

- Burdens that are hidden are just as real as those that are visible.
- It seems difficult to demonstrate the fairness of taxes whose incidence is unknown.
- Better analysis can help to inform policy.

Considering Equity and Efficiency Together, 1: Fiscal Competition

- People, consumers, and businesses can work,buy, and invest in different locations.
- Mobility means taxes affect locational choices (efficiency), and constrains the redistributive capacity of state/local governments (equity).
- These effects (efficiency losses, constraints on redistribution) likely more important in long run. Short-run/long-run tradeoffs.

Considering Equity and Efficiency Together, 2: Tax Expenditures

- Tax expenditures: specialized tax breaks are like selective subsidies.
- Likely to interfere with efficiency/neutrality.
- Equity consequences: often very opaque.
- Should businesses compete on cost, innovation, consumer satisfaction – or on ability to obtain special preferences not available to other firms/industries?

I.B. Policy Constraints: Cash-Flow/ Intertemporal Budget Constraints

- Two sides to the fiscal accounts: Revenues and Expenditures
- Period-by-period cash flow constraint:

$E_t = R_t + B_t$ (Spending = Revenues + Borrowing)

The Intertemporal Budget Constraint

- Intertemporal linkages: Today's borrowing (or savings) affects tomorrow's feasible choices.
- The intertemporal budget constraint:

  $PV(E_{0,} ,\ldots, E_t \ldots) + B_0 = PV(R_0 ,\ldots, R_t ,\ldots)$
- The PV of current and future expenditures and outstanding net liabilities as of today MUST equal the PV of current and future revenues.

Lessons from the GBC

- Tax and expenditure sides of fiscal accounts are distinct, but linked.
- The RHS of the GBC contains all tax and nontax revenues.
- The LHS of the GBC contains all expenditures.
- Intertemporal linkages: debt, investment, reserve funds, deferred compensation, etc.

What is “tax reform”?

- Conceptually, “tax reform” means changing terms *within* the RHS of the GBC. Examples:

  Increase sales taxes with *offsetting* reductions in income taxes.

  Remove *special* tax preferences, use added revenue for *general* rate reductions.

  Increase nontax revenues with *offsetting* reductions in taxes.

Tax Reform Analysis

- Each of these (and many other) possible tax reforms raise equity and efficiency questions.
- They do *not* (as posed) raise questions about whether revenues (and expenditures) should be higher or lower.

Expenditure Analysis

- Focusing on tax reform in this sense leaves plenty of work to do.
- But expenditure analysis is equally important!
- Expenditures *can* be, *should* be, but rarely *are* subjected to careful economic analysis. (A topic for another day?)

Summary

- Basic economic criteria for policy evaluation: efficiency and equity.
- Policies are made subject to constraints. These define what is *feasible*, and force tradeoffs.
- Tax and expenditures each deserve careful analysis. Our focus today is tax reform.

II. Taxation in a Changing Economic Environment: Some Issues for Today (and Tomorrow?)

The Changing Context of Tax Analysis

- As economic and fiscal environments change, different issues attract attention.
- Three examples:

A. Changing industrial structure (service/non-service sectors).

B. Revenue volatility.

C. Competition for human and nonhuman capital.

A. Growth of the Service Sector and Sales Taxation

- Kentucky’s sales tax base substantially *exempts* services, but *does* tax many B2B transactions.
- *Almost half* of sales tax revenue in Kentucky comes from taxation of sales to businesses. It is therefore by no means “just” a tax on consumption.

Economic Consequences of Current Sales Tax

- Exemption of services provided to households distorts consumption and production patterns.
- Taxation of sales to businesses also distorts production and consumption decisions.
- Neither aspect of this system compares favorably on efficiency/equity grounds with a simple uniform tax on all consumption.

The Current Sales Tax, in Outline

	Tangible Goods	Services
Sold to Consumers:	Taxable	Not Taxable
Sold to Firms:	Taxable	Not Taxable

The Structure of a Uniform Sales Tax on Consumption

	Tangible Goods	Services
Sold to Consumers:	Taxable	Taxable
Sold to Firms:	Not Taxable	Not Taxable

B. Revenue Volatility

- Revenues have fallen sharply during current economic crisis.
- Shortfalls have been partially mitigated through depletion of rainy-day fund, Federal assistance.
- Some expenditure-side adjustment. (How harmful are expenditure disruptions?)

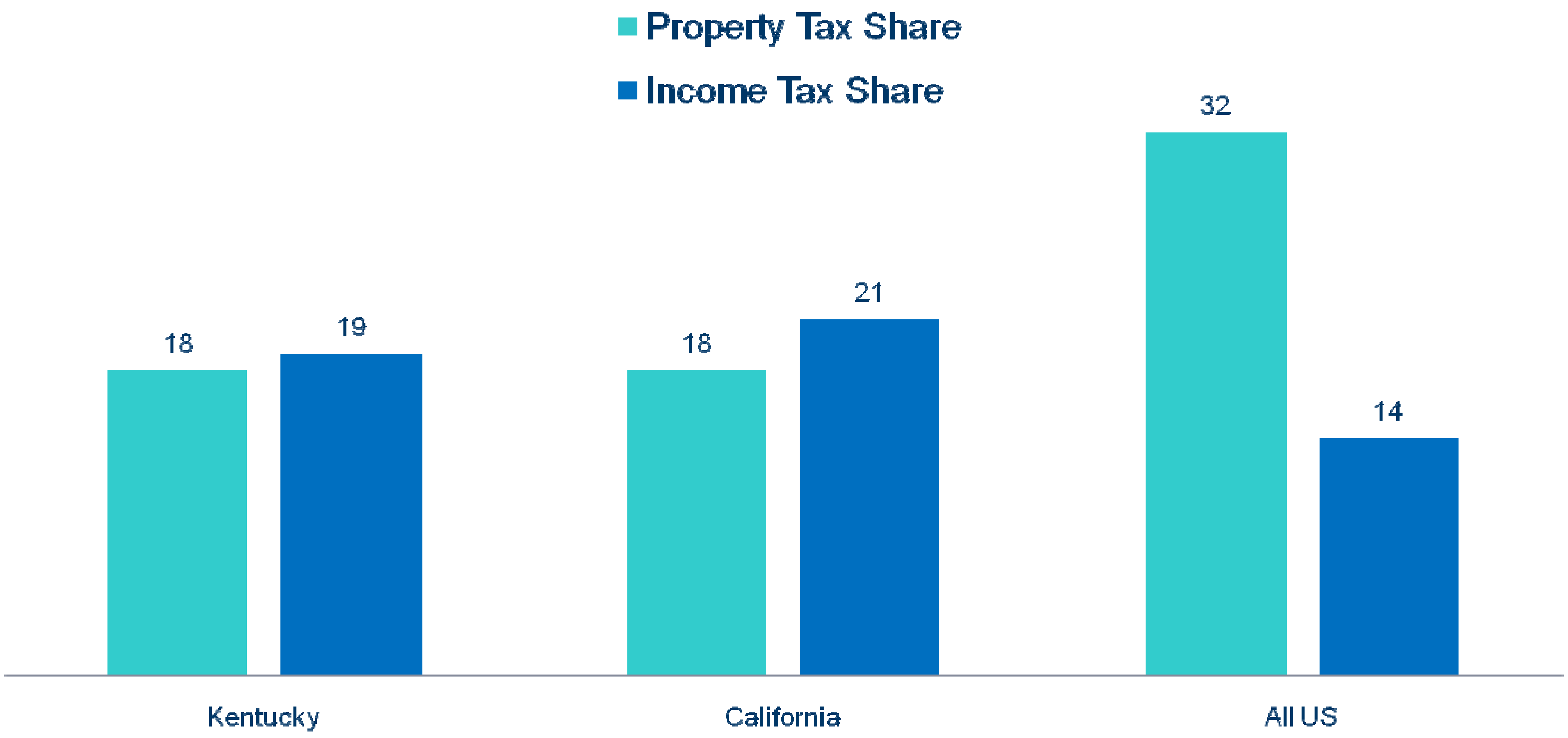
Can Revenues Be Stabilized?

- Rebuilding financial reserves can help to insure against future downturns.
- So might a change in Kentucky’s revenue structure: Not all taxes are equally sensitive to economic fluctuations.

The Tax Mix and Revenue Volatility

- Kentucky, like California, differs from most states in exceptionally heavy reliance on income taxes and only modest reliance on property taxes. (State + local in KY, state only in CA.)
- Income taxes are more volatile than property taxes.

Sources of State-Local Revenues: Kentucky, California, and All US. (Percentage Shares, 2006)



How Kentucky Could Rebalance the Income/Property Tax Mix

- Option 1: Increase state property taxes, reduce state income taxes.
- Option 2: Cut assistance to localities, allow/encourage greater local reliance on property taxes.

  An aside: Does HB44 constrain local governments? Maybe, maybe not. We have run a 30-year experiment, but nobody bothered to keep the lab notes!

Weighing the Options

- A potential efficiency/equity tradeoff.
- With highly diverse regions, there are potential efficiency gains from adapting policies to local conditions. (Option 2.)
- A more centralized approach (option 1) may sacrifice efficiency gains, but concentration of resources in Frankfort can help to finance transfers from “haves” to “have-nots”.

C. Competition for Human and Nonhuman Capital

- Kentucky is a small state in a large economy.
- Ability to transfer income is probably limited, in LR, by “migration constraint”.
- Heavy reliance on income taxes, in LR, probably reduces proportion of high-income households in Kentucky.
- What alternatives? How would these affect LR development?

III. Conclusion

The Big Questions

- What tax policies can promote economic development in Kentucky?
- Can efficiency be improved? Does greater efficiency harm equity?
- What tax policies best promote equity? At what efficiency cost?

A Modest Proposal

- Policy debates can be informed by better policy analysis.
- The need for policy analysis is perennial.
- A modest proposal: Can the state and its academic institutions work together to improve data collection and capacity for policy analysis?

References

For this speaker's previous discussions of issues mentioned here, please consult:

1. Chapters 1, 2, 3, and 6 in *Financing State and Local Government.* (Frankfort: Long Term Policy Research Center, 2001).

2. "Business Taxation in Kentucky". Report prepared for Kentucky Chamber of Commerce, 2003.

3. "Local Government Finance in Kentucky: Time for Reform?", *Kentucky Annual Economic Report.* (Lexington: Center for Economic and Business Research, 2007).

4. "Long Term Fiscal Risks Facing Kentucky: The Federal Dimension". (Presented to Kentucky Long Term Policy Research Center Annual Conference, Covington, 2008.)

5. "Intergovernmental Transfers to Local Governments". (Cambridge: Lincoln Institute of Land Policy, forthcoming.)